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C O N F I D E N T I A L SECTION 01 OF 04 BERLIN 000548

STATE FOR EEB/OMA (WHITTINGTON), DRL/ILCSR, EUR/RUS,
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SIPDIS

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TAGS: EFIN ECON ELAB PREL GM

SUBJECT: GERMANS SHARE U.S. CONCERNS ABOUT UKRAINE

Classified By: EMIN ROBERT POLLARD FOR REASONS 1.4 (B) AND (D).

¶1. (C) SUMMARY. In meetings on April 30, 2009, David Lipton of the NSC and Eric Meyer of the Treasury Department shared concerns about Ukraine's deteriorating public finances and shaky banking sector with senior officials from the German Ministries of Economics, Finance and Foreign Affairs, as well as the Chancellor's Office. Both sides agreed that political squabbles between the Ukrainian President and Prime Minister were jeopardizing much needed economic reforms. There was agreement that bilateral assistance to Ukraine would not be productive in the current environment and that a continued multilateral approach was preferable. German officials, long skeptical of looser IMF lending standards, were concerned about reports that IMF conditionality in Ukraine was perceived by some as weak. With regard to the German economy, officials acknowledged recent weaknesses and expressed frustration with the European Commission's interventions with countries, efforts to tackle problems stemming from the financial and economic crises. END SUMMARY.

U.S. MESSAGE

¶2. (C) In April 30, 2009 meetings with senior German officials in Berlin, David Lipton, Senior Director for International Economics, National Security Council (NSC), and Eric Meyer, Deputy Assistant Secretary, Treasury Department, expressed their concerns over developments in Ukraine. Having joined Deputy Secretary of State Steinberg in meetings with President Yushchenko and Prime Minister Tymoshenko in Kyiv days earlier, they said the two primary concerns were: 1) the Ukrainian government's budget deficit and 2) the weak Ukrainian banking sector. They also said they had sought to reassure the Ukrainian government that the U.S. "restart with Russia" was not a threat to Ukraine.

¶3. (C) Bickering between Ukrainian President Yushchenko and Prime Minister Tymoshenko, particularly as elections drew closer, was diverting attention away from implementing much needed reforms as agreed with the International Monetary Fund (IMF), Lipton told his interlocutors. President Yushchenko and others felt the IMF's approach was too soft, making it difficult for the President to pressure the government to cut spending further and stop intervening in the economy. In the near-term, however, Yushchenko and Tymoshenko should agree to align their interests with those of the Ukrainian economy.

¶4. (C) Aside from the Finance Minister, Ukrainian

counterparts did not ask for bilateral assistance during their meetings, but Prime Minister Nemyria had previously sent a letter to the United States seeking budget support. The World Bank also appeared ready to host a donors' conference. The United States had indicated to Ukrainian counterparts that bilateral support was unlikely. Lipton said he was not opposed to providing more funds through the IMF if they were truly needed and if the political environment improved, but it would be politically difficult to ask Congress for bilateral aid at this time. In the meantime, IMF funding should be disbursed "in drips and drabs," so that donors could maintain pressure. Tymoshenko would like 100 percent of the IMF money to go towards budgetary support, he added. German counterparts reiterated that Germany would not provide bilateral support, but expected a contribution from the EU Commission's macro-financial instrument.

¶5. (C) Lipton noted that the Prime Minister was overburdened by serving as de facto "finance minister, deputy prime minister and head of the bank restructuring group," all at the same time. There was also a risk that international support could simply be used to pay for imported Russian gas, especially given the Ukrainian desire to refill depleted reserves. Lipton said he would look into IMF conditionality and discourage the World Bank from hosting a donors' conference; he asked his German interlocutors to do the same.

¶6. (C) Lipton was skeptical that the recapitalization plan for Ukraine's domestic banks was "as solid as the IMF thinks." There needed to be a more precise and transparent

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set of principles for recapitalization and treatment of creditors and shareholders of the seven systemically important banks, he explained. Neither the Ukrainian Prime Minister nor the IMF team handling Ukraine could articulate any details beyond two basic requirements: 1) that capital adequacy should be 10 percent; and 2) that the government voting stake should be 75 percent plus 1 share. He said that foreign banks had pledged to maintain adequate capital in Ukrainian subsidiaries, but that evolving circumstances could make this difficult in practice. Lipton suggested that Western European governments take steps to ensure banks in their jurisdiction did not suddenly withdraw capital from Ukrainian subsidiaries.

¶7. (C) On Poland, where he had also visited earlier in the week, Lipton said the country was weathering the storm reasonably well, but he was concerned about the banking system. As the sector was mostly foreign-owned, decisions by home regulators had profound implications for Polish banks. Lipton hoped Germany would play a proactive coordinating role in Europe to ensure decisions by outside regulators did not negatively affect the Polish banking sector.

PFAFFENBACH, MINISTRY OF ECONOMICS

¶8. (C) Bernd Pfaffenbach, State Secretary, Ministry of Economics and Technology, commented that he was concerned about the situation in Ukraine. He had just returned from the annual meeting in Kyiv of the German-Ukrainian High Level Group (HLG), in which his Ukrainian counterpart was Deputy Prime Minister Nemyria. He agreed that a bilateral donors' conference was out of the question, and suggested the European Bank for Reconstruction and Development (EBRD) and European Investment Bank (EIB) (in addition to the IMF) could help if more funding were truly needed. On the banking sector, Pfaffenbach noted that Commerzbank's and Deutsche Bank's concerns over Ukraine had "nothing to do with subprime," but rather involved foreign-denominated loans by Ukrainian subsidiaries. Pfaffenbach said that 35 percent of Germany's gas came via Ukrainian pipelines, and reported having unpleasant memories of having to deal with the Russia-Ukraine dispute over the Christmas holidays.

Pfaffenbach acknowledged that Germany had some "Hermes exposure" (German government export guarantees) in Ukraine.

VON FRITSCH, MINISTRY OF FOREIGN AFFAIRS

¶19. (C) Ruediger von Fritsch, Director General for Economic Affairs, Ministry of Foreign Affairs, began by joking that Cyprus was now the top foreign investor in Ukraine. Having also attended the HLG meeting in Kyiv earlier in the week, von Fritsch reported that the main German message had been that the "Ukrainians were not doing their homework" on reform. They were, in his view, "putting their energy into the wrong issues," such as political maneuvering. Von Fritsch said Germany agreed with the United States that Ukraine should not expect bilateral assistance, adding that "Paris would never accept a donors' conference." He said that when the IMF disbursed its second tranche of assistance, the EU Commission would also pitch in. Unfortunately, remarked von Fritsch, the Ukrainian government was taxing foreign investors and using the proceeds to fund election activities. While noting the European Union (EU) was taking steps to integrate Ukraine over the long-term, von Fritsch emphasized the importance of consulting the Russians in dealing with Ukraine. He acknowledged, however, the need to be careful, as the "Russians always play a zero-sum game." Von Fritsch cited Tymoshenko's behavior during Russia's 2008 invasion of Georgia as an example of how she always tried to please the Russians. Von Fritsch was skeptical of a suggestion by Lipton that there could presently be a window of opportunity for constitutional reform in Ukraine.

WEIDMANN, CHANCELLERY

¶10. (C) Jens Weidmann, Economic Advisor to Chancellor Merkel, BERLIN 00000548 003 OF 004

was surprised that Lipton and Meyer urged closer scrutiny of Ukraine, having assumed they would encourage looser IMF conditionality. While acknowledging "Germany's responsibility" for Ukraine, Weidmann stressed the need for a "multilateral approach." He also said EBRD funding would likely increase as a result of G-20 Summit commitments.

¶11. (C) On the German economy, Weidmann said the German government hoped its plan for dealing with troubled bank assets would be in place by the end of May. Weidmann was sympathetic to Lipton's suggestion that Germany consider "shifting the burden of future losses to common shareholders rather than to the bank as a whole." It could be difficult, however, "to impose directly on shareholders," given German law, he said. Citing the case of the troubled lender Hypo Real Estate (HRE), he thought it unlikely shareholders would approve such a scheme. In the case of Commerzbank, which has applied for bailout funds from the German government, Weidmann thought it "ridiculous" that EU competition authorities were hindering "solutions to serious problems" in the name of the common market. On Opel, Weidmann said U.S.-German communication had been very strong, but lamented that problems with "bridge financing" could hold up a deal. He added that there were "screws the U.S. could turn," particularly regarding patents held by General Motors, which could increase the value of Opel.

WENZEL, MINISTRY OF FINANCE

¶12. (C) Rolf Wenzel, Director General, Ministry of Finance, reported he had also participated in the HLG meeting in Kyiv. Echoing other German officials' concerns, he noted there was little continuity among high-level Ukrainian officials under Deputy Prime Minister Nemyria: "Every time we meet, there are new faces." Because of the constant turnover, he posited, the Ukrainians listened but gave little thought to

implementation. Wenzel lamented the high level of corruption in Ukraine, particularly in the regions, where officials routinely asked for \$200,000 in exchange for a business license. He also noted the "unsteady application of the VAT rebate." Wenzel acknowledged that Deputy Prime Minister Nemyria was "competent," calling him "one of the better informed," though "isolated from his staff."

¶13. (C) Noting a recent joint letter by German Foreign Minister Steinmeier and Polish Foreign Minister Sikorski pledging help to Ukraine, Wenzel stressed that Germany's intention was to act multilaterally rather than bilaterally. Wenzel felt that the IMF was "confused" these days over the role of conditionality, particularly since the creation of the flexible credit facility. He also welcomed new bilateral contributions to build up the IMF's resources. He also noted the European Central Bank's (ECB's) concerns that the new IMF Special Drawing Rights (SDRs) agreed at the G-20 Summit in London would create too much liquidity, adding that German Central Bank ("Bundesbank") President Axel Weber was unsupportive of the SDR concept. Wenzel was worried about the possibility that Mexico would "draw" on its Flexible Credit Line (FCL) from the IMF and the precedent this might set for other countries like Poland. Lipton countered that he did not think this was a concern.

¶14. (C) Wenzel highlighted the recent De Larosiere report on organizing supervision of financial institutions and markets in the EU. The report was "still on the table," he explained, and there could be a "detailed proposal" from EU Finance Ministers (ECOFIN) by September. De Larosiere's recommendations would mean a "transfer of sovereignty" to Brussels, he added, as "colleges of supervisors could be directed." Challenges to moving towards an EU-wide system remained, particularly with the ECB. Wenzel was also concerned that national authorities might ask a college of supervisors, member to divulge confidential information about a particular bank, even if that bank was not headquartered in the country. He lamented the fact that the EU Commission, whose approval was needed for bank bailouts such as that of Commerzbank, was requiring recipients to close down subsidiaries as a way of improving their balance sheet.

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¶15. (C) Citing the 500 billion euro German bank rescue fund ("Soffin"), Wenzel said there had been no instances to date where the EU Commission had breached confidentiality. The fund had already disbursed or used 130 billion euros, including 18 billion euros for Commerzbank. In the case of Hypo Real Estate (HRE), Wenzel said the German government hoped to take over the troubled lender through "market operations," but is prepared to expropriate if necessary, as authorized under certain circumstances by recently approved legislation. As for dealing with banks' impaired assets, Wenzel said the German government had planned no "stress tests" and there would be no specified capital base. He commented that the state-owned banks ("Landesbanken") wanted to purge not only "toxic assets" but also "non-strategic assets." The federal government sought to consolidate the Landesbanken, he said, but he did not specify a preferred model.

COMMENT

¶16. (C) German officials broadly agree with the U.S. approach on Ukraine. Concerns that Ukraine's economic instability will spill over into the political realm run deep, but the preferred avenue for assistance remains multilateral. They believe that stricter IMF conditionality is another useful stick, but needs to be clarified. On Russia, the Foreign Ministry is fearful that western efforts to stabilize the Ukrainian economy could alienate Moscow, so welcomed our willingness to engage Russia. There is visible tension

between German authorities and the European Commission over dealing with the financial and economic crises. The Germans are frustrated that Brussels is, in their view, preventing member states from dealing with the crisis in their own economies, which does not augur well for future coordination at the EU-level.

Koenig